Internal Revenue Service

memorandum

date: JUN -4 1991

to: Jack E. Prestrud, Special Trial Attorney CC:CLE

from: Technical Assistant to the Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Tax Litigation Advice [redacted] - Purchased Mortgage Servicing Rights

This is in reference to the conversations we have had regarding the above. As you may recall, I sent an interim response to you concerning amortization of the right to service, servicing escrow and servicing principal and interest (P&I) float. The interim response consisted of informal ruminations by the Office of the Assistant Chief Counsel (Income Tax and Accounting). I pledged to communicate further with you after the appropriate branches in the Tax Litigation Division and I had an opportunity to analyze and discuss IT&A's informal response. This is the promised follow-up.

We are in agreement that there is substantial authority permitting the amortization of purchased rights to service existing mortgage loans and rights to use escrow funds associated with existing loans provided the test of Treas. Reg. § 1.167(a)-3 is satisfied, i.e., (1) the asset has an ascertainable value separate and distinct from goodwill and going concern value and (2) the asset has a limited useful life that can be determined with reasonable certainty. Houston Chronicle Publishing Co. v. United States, 481 F.2d 1240 (5th Cir. 1973), cert. denied, 414 U.S. 1129 (1974). Of course, these conclusions apply only to purchased mortgage servicing rights associated with existing loans. The costs allocable to mortgage servicing rights associated with future loans are inextricably linked to the acquisition of goodwill or going concern value and are not amortizable. See First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677, 689-690 (1970), acq., 1972-1 C.B.2.

The facts underlying [redacted]'s purchase of [redacted] are similar to those of First Pennsylvania Banking & Trust in that books, records, real estate, equipment and personnel were acquired in addition to mortgage servicing rights. Acquisition of such items would enable the purchaser to succeed the acquired entity as mortgage correspondent for future mortgages. Under those circumstances, the Tax Court found that the taxpayer had

purchased, in addition to mortgage servicing rights, an asset in the nature of goodwill that formed part of going concern value. Accordingly, in the instant case, much of the value may be attributable to nonamortizable assets.

As IT&A properly notes, there is very little authority regarding amortization of P&I Float, but it is conceivable that the cost allocable to such an asset may be amortizable pursuant to the rationale of First Pennsylvania Banking & Trust Co., provided that such allocable cost relates to existing mortgages, has a value separate and distinct from goodwill and going concern value, and has a useful life the duration of which can be ascertained with reasonable accuracy. However, we are concerned that allowing amortization of P&I Float, an asset that is essentially the short term use of money belonging to others, would jeopardize the rule we are attempting to establish in core deposit and similar intangible asset cases. Our position in the core deposit cases has been that the use of low cost funds is inextricably linked to continued customer patronage and is not an amortizable asset. We have recommended appeal of the decision in Colorado National Bankshares, Inc. v. Commissioner, T.C. Memo. 1990-495, pending entry, in the hope of establishing favorable precedent concerning the amortization of core deposits and creating a conflict with the Eleventh Circuit which affirmed the Tax Court in Citizens and Southern Corp. v. Commissioner, 900 F.2d 266 (11th Cir. 1990). Thus, in order to protect our litigating position in the core deposits arena, we cannot now recommend conceding that P&I Float is an amortizable asset.

Further, although P&I Float and Servicing Escrow may constitute separable assets, the value of the mortgage servicing contracts may include the values attributable to P&I Float and Escrow. Thus, the potential for double counting exists. Also, IT&A's memorandum lists "right to service" and "mortgage servicing contracts" as two assets broken out separately by the taxpayer. Again, these assets may be one and the same and the potential for double counting is manifest. Perhaps these points should be clarified with Examination. We also note that FI&P is preparing a memorandum to us on the favorable financing issue which could affect the P&I Float issue. If necessary, we will contact you when we receive FI&P's memorandum.

With regard to mortgage pipeline, we understand that this asset involves revenues anticipated from mortgages originated but not yet closed. An estimate is made of the portion reasonably expected to close and a useful life is then projected by the taxpayer. It is difficult to provide you with any assurances without formal consideration, but it may be reasonable to assume that loans that have originated but not closed are mere manifestations of possible future mortgage contracts and, as such, are not subject to amortization under the rationale of First Pennsylvania Banking & Trust Co..

As a final matter, we understand that you have been in touch with Ted Sanderson of this division and the Office of the Assistant Chief Counsel (Financial Institutions and Products) concerning the I.R.C. § 1286 aspects of mortgage servicing rights. Our understanding is that, despite FI&P's tentative conclusion that section 1286 will require that the original issue discount rules be applied in recovering basis of the strip component, if any, of purchased mortgage servicing rights, the section 167 analysis discussed herein and in IT&A's memorandum continues to be vital. Such analysis will determine the goodwill portion of the mortgage servicing rights as well as the basis recovery method of the compensatory component. We understand that Ted and FI&P will continue to assist you.

Please do not hesitate to call on us if we can be of any further assistance.

LEWIS J. FERNANDEZ

Attachment: IT&A memo dated April 10, 1991

Internal Revenue Service

memorandum

date: OCT 10 1991

to: Lewis J. Fernandez
Technical Assistant to the Associate Chief Counsel (Lit.)

from: Associate Chief Counsel
(Income Tax & Accounting)

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subject: Amortization of Acquisition Costs for Amounts Spent to Purchase Mortgage Service Companies

Issue

Pursuant to your request for assistance, we have been asked to determine whether the following items constitute assets the cost of which may be amortized: (1) right to service; (2) servicing escrow; and (3) servicing P & I float.

Conclusion

The courts and the Service have consistently held that mortgage servicing contracts constitute separate assets the cost of which may be amortizable. Similarly, the cost of acquiring use of escrow funds may be amortizable. While there is less authority for amortizing the cost of acquiring "float", such amounts also may be amortizable. In order for any of the foregoing to be amortized, [redacted] must be able to demonstrate that it has a distinct separate cost basis in the asset and that the asset has a limited useful life the duration of which can be ascertained with reasonable certainty.

Facts

In [redacted], [redacted], through a subsidiary ([redacted]), acquired two mortgage service companies. These companies, [redacted] and the [redacted] "family" of companies, were purchased for an aggregate amount of approximately $[redacted]. This amount was allocated to the following assets:

Asset	[redacted]	[redacted]
Tangibles:	$[redacted]	$[redacted]
Intangibles:		
Right to Service	$[redacted]	$[redacted]
Servicing Escrow		
Servicing P & I Float		
Assembled Workforce		[redacted]
Computer Software		
Mortgage Pipeline		
Mtg. Servicing Contracts		
Leasehold		[redacted]
Total	$[redacted]	$[redacted]

The [redacted] group is essentially a mortgage banking operation which originates, sells and services residential and commercial mortgages. This business continued in operation after being acquired by [redacted]. With respect to [redacted], [redacted] obtained only the servicing rights and related books, records, real estate, and related equipment. [redacted]'s other assets were disposed of prior to its acquisition and it apparently continues its loan origination business.

[redacted] is claiming amortization for its cost of acquiring the right to service the mortgages. In addition, [redacted] is amortizing the cost of obtaining use of escrow funds. Value is attributed to the escrow based on savings attributed to using the escrow funds as compensating balances to reduce the cost of [redacted]'s borrowings. A third asset for which amortization is claimed is the "float" on the principal and interest payments it receives from borrowers. This is the time lag between receipt of funds by [redacted] and disbursement of those funds to the lenders. These excess funds are apparently also used to reduce the [redacted]'s cost of borrowing.

Discussion

Section 167(a) provides, in part, that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business. The term "property" includes intangibles. The rules for the allowance of the depreciation deduction for intangibles are set forth in section 1.167(a)-3 of the Income Tax Regulations. This regulation provides as follows:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the

> length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill.

In order to claim a depreciation deduction under the forgoing regulation a taxpayer must show that the intangible asset in question (1) has an ascertainable cost basis separate and distinct from goodwill or going concern value, and (2) has a limited useful life, the duration of which can be ascertained with reasonable certainty. The determination of whether these requirements have been met in any given case is essentially a factual question.

Servicing Agreement

The courts and the Service have recognized that the acquisition cost of loan servicing agreements may be amortized under section 167. Servicing rights may constitute a separate asset and be amortized in appropriate circumstances. Securities-Intermountain, Inc. v. United States, 460 F.2d 261 (9th Cir., 1972) aff'g 70-1 USTC ¶9444; Western Mortgage Corp. v. United States, 308 F. Supp. 333 (C.D. Cal. 1969); First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1970) acq. 1972-1 C.B. 2; First National Bank of Omaha v. Commissioner, T.C. Memo 75-67.

In First Pennsylvania Banking & Trust Co. v. Commissioner, the issue before the Tax Court was whether the entire amount paid by the taxpayer to acquire a mortgage servicing business could be amortized. The taxpayer argued that the entire amount was amortizable. The Service conceded that so much of the purchase price as could be allocated to the right to service was amortizable. 56 T.C. at 686. However, the Service contended that a portion of the purchase price was properly allocated to good will and going concern value. The Tax Court agreed with the Service position. 56 T.C. at 691. In reaching this result the court stated that:

> The fact that no mention was made in the contract concerning the servicing of "future loans" does not preclude a finding that a part of the consideration was paid for this opportunity, and we so hold. The form in which the transaction is cast cannot overshadow its substance.

56 T.C. at 689. In another case the taxpayer, a mortgage servicing company, purchased the right to service loans in

another region from an unrelated company. Securities-Intermountain, Inc. v. United States, 460 F.2d 261 (9th Cir., 1972) aff'g 70-1 USTC ¶9444. The taxpayer claimed an amortization deduction for the entire purchase price while the Service argued that part of the price was attributable to good will; in particular, to acquiring a business relationship in that market with a particular correspondent. The court held that the entire purchase price could be amortized because, on the facts before it, nothing else was acquired. Note that in this case the taxpayer was already in the business and had an existing relationship with the correspondent whose servicing business was acquired.

Other cases have reached a similar result. Western Mortgage Corp. v. United States involved the purchaser's treatment of the cost of acquiring the right to service certain mortgages. The cost was held to be an amortizable expense.[1] However, part of the purchase price was allocated by the court to the right to do future business with a particular mortgage correspondent - i.e., "going concern value". In First National Bank of Omaha v. Commissioner the Tax Court allowed the petitioner to amortize that part of its cost of acquiring a mortgage servicing business which was allocable to servicing income. The remainder which was paid for good will was not amortizable.

Similar results have been obtained in cases dealing with the seller's tax treatment. In Bankers Guarantee Title & Trust Co. v. United States, 290 F. Supp. 522 (N.D. Ohio, 1968) aff'd per curium 418 F.2d 1084 (6th Cir., 1969) the proper tax treatment of the seller of a portion of a mortgage servicing business (the seller continued in business afterward) was before the court. The seller argued that the entire proceeds were capital gain. The court found that a portion of the proceeds was taxable as ordinary income. The portion so taxable was computed by reference to the anticipated servicing income which was transferred. That portion of the proceeds attributable to good will was afforded capital gains treatment. The court noted, in dicta, that the purchaser would be able to amortize that portion of the price attributable to servicing income. A similar result was reached in Realty Loan Corp. v. Commissioner, 54 T.C. 1063 (1970) which also dealt with the tax treatment of a seller. That part of the sales proceeds attributable to good will was held to be capital gains while the part attributable to future income was held to constitute ordinary income. In considering the allocation of the price among the assets the court stated that "[i]t would not be expected that a reasonable person would pay the full price of the income it expected to receive over the lives of the mortgages." 54 T.C. at 1094. In other words, the court did not believe that a buyer would pay an amount equal to

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[1] In this case the court noted that the "indivisible asset" rule is not applicable to mortgage servicing contracts.

the entire stream of servicing income in order to acquire the right to service.

The above discussed cases demonstrate that the courts have consistently recognized that the cost of acquiring mortgage servicing rights may be amortizable. The Service has consistently agreed with this position. In First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1970) acq. 1972-1 C.B. 2 the Service acquiesced to the result. In another case, G.C.M. 31350 considered two situations. In one situation part of the purchase price, on the facts, was paid for acquisition of an ongoing business - obtaining relationships with lenders was a major concern. Amortization was not allowed. In the second situation, the taxpayer established factually that the purchase price was only for the right to service existing loans and not for a continuing line of business. Amortization was allowed. The GCM stated that whether what is obtained is an amortizable asset depends on the facts and circumstances of each case. In G.C.M. 30156 the taxpayer, a mortgage servicing company, requested a ruling that the cost of its buying another mortgage lending company's servicing contracts was amortizable. This request formed the basis for a proposed revenue ruling which was considered in the GCM. The GCM indicates that this is a factual issue which depends on what rights are obtained by the taxpayer with respect to future business. If the taxpayer anticipates obtaining future business (even if not spelled out in the contract but rather as a result of trade custom) good will may be present. Otherwise, the cost of acquiring servicing contracts is amortizable. In deciding how to respond in Securities-Intermountain, Inc. v. United States, 460 F.2d 261 (9th Cir., 1972) aff'g 70-1 USTC ¶9444 the Service conceded that so much of the purchase price as could reasonably be allocated to the right to receive servicing income was depreciable. The disputed factual issue was whether the taxpayer obtained more than just servicing rights - i.e., did they get the right to future business or an introduction to a new lender. Brief 25065 (note 3); see also O.M. 17010 (appeal not recommended as court was correct in holding that whether an amortizable asset was acquired is a factual issue). These memoranda demonstrate that the Service recognizes that the cost of acquiring mortgage servicing rights may be amortized.

Escrow Deposits

There is less authority dealing with the treatment of escrow accounts. However, both the courts and the Service has recognized that escrow accounts may constitute separately amortizable assets. The principal case in this area is First Pennsylvania Banking & Trust Co. v. Commissioner, 56 T.C. 677 (1970) acq. 1972-1 C.B. 2. In this case the court noted that the taxpayer acquired the right to use the escrows associated with the mortgages it was servicing. 56 T.C. at 689. It stated that "[t]hese escrows could be deposited in its banking department where petitioner would be able to utilize the funds interest free

in its own lending operations and hence derive profit therefrom." 56 T.C. at 689. In First National Bank of Omaha v. Commissioner, T.C. Memo 75-67 the court noted, when determining how to allocate the purchase price among assets, that the taxpayer did not obtain the right to use the related escrow deposits unlike the situation in Pennsylvania Banking & Trust Co. Similar recognition of escrows as a separate item is found in Bankers Guarantee Title & Trust Co. v. United States, 290 F. Supp. 522 (N.D. Ohio, 1968) aff'd per curium 418 F.2d 1084 (6th Cir., 1969). In this case, the court noted that part of what was sold was "the right to utilize the Metropolitan mortgagors' monthly escrow deposits to enhance [taxpayer's] credit standing, and the 'feeder' activities of insurance and real estate carried on by [taxpayer's] parent corporation also were lost." 68-2 U.S.T.C. at 87,863. The Tax Court recently reaffirmed, in dicta, its holding in Pennsylvania Banking & Trust Co. that the opportunity to use existing escrow funds is an amortizable intangible asset. Citizens and Southern Corp. v. Commissioner, 91 T.C. 463, 490 (1988). Thus, it seems clear that escrow funds can constitute an amortizable asset.

Float

There is even less direct authority dealing with the treatment of "float." However, Pennsylvania Banking & Trust Co. provides some support for amortizing the cost of acquiring float in appropriate circumstances. In that case the court described the escrow as consisting of "payments made monthly in advance to furnish sufficient funds for the servicing agent to pay insurance premiums and real estate taxes on the property. These escrows could be deposited in its banking department where petitioner would be able to utilize the funds interest free in its own lending operations and hence derive profit therefrom." 56 T.C. at 689. This description seems equally applicable to the "float" which is generated by the timing difference between receiving funds and paying out the same funds. Indeed, in Citizens and Southern Corp. v. Commissioner the court noted that the use of low cost funds is a valuable asset. 91 T.C. at 489. Thus, although no direct authority was found, it seems that if a distinct cost basis can be established and if a useful life can be established the cost of acquiring "float" should be amortizable.

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